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The same principle leads to the conclusion, that the encouragement of mere consumption is no benefit to commerce; for the difficulty lies in supplying the means, not in stimulating the desire for consumption; and we have seen that production alone, furnishes those means. Thus, it is the aim of good government to stimulate production, of bad government to encourage consumption.

— Jean-Baptiste Say, *Traité d'Economie Politique*, 1803

UNSUSTAINABLE GROWTH

Renewed weakness in the U.S. economy has hardly come as a surprise to us. It is the inexorable outgrowth of an economic recovery that has been of highly dubious quality right from the start. The U.S. economy is plagued by an extraordinary array of growth-impairing imbalances: a record-high trade deficit, a record-high budget deficit, record-high household indebtedness, record-low national saving and asset price bubbles supporting record-high consumer spending.

Any other country faced with these monstrous domestic and external imbalances would have endured panicky capital flight and a collapsing currency, forcing its central bank to drastic monetary tightening. But the U.S. central bank and the dollar were spared this fate because the central banks of the Asian surplus countries stepped in, accumulating any amount of dollars needed to avoid an undesired rise of their currencies.

In 2003, such dollar purchases by foreign central banks amounted to a stunning $616.6 billion, after $351.9 billion the year before. The total reserves of emerging Asia rose by over $350 billion between the beginning of 2003 and March 2004. Over the same time, Japan's central bank purchased $316 billion worth of U.S. assets. The biggest buyer in emerging Asia was the central bank of China.

These huge and soaring dollar purchases by foreign central banks were crucial in allowing the U.S. Federal Reserve to pursue its ultra-loose monetary policy with ultra-low interest rates. As we have often stressed, this in combination with equally loose fiscal policy has prevented a deeper recession, but the question is whether or not these policies have laid the foundation for sustained economic growth in the longer run.

In our view, it is bad policy on both sides. The Asian central banks accommodate the credit excesses in the United States, and in doing so, fuel rampant credit excesses in their own countries. Japan's horrible aftermath over more than a decade after its credit excesses in the late 1980s does not seem to deter anybody. The United States, on the other hand, is losing jobs to Asia.

Both are courting extraordinary credit excess, but with a crucial difference: In the United States, the credit excess went and continues to go overwhelmingly into asset prices and personal consumption; in Asia, it goes overwhelmingly into capital investment and production, essentially creating a mass of overcapacity and malinvestments. The result is an unprecedented symbiosis between the two continents: The Americans borrow and consume, and the Asians produce.

SHORT-LIVED "SOFT PATCH" OR…?

The U.S. economy has abruptly weakened. Is this weakness just a short-lived "soft patch" caused by higher oil prices, as emphasized by Fed Chairman Alan Greenspan and readily believed by the eternally bullish consensus? Or does it represent the beginning of a more severe downshift to subpar corporate and economic performance, if not worse?

At issue in particular is a slowdown in consumer spending. From the start of 2004 through July, real consumer

spending rose by $122.2 billion. That is $209.5 billion, or 2.8% at annual rate, and compares with an overall increase of $232.2 billion (3.3%) in 2003 and of $213 billion (3.1%) in 2002. For perspective, during the boom years 1999–2000, it had growth rates of 5.1% and 4.7%.

Though this deterioration is not dramatic, it also does not suggest an ongoing recovery. Yet the aggregates hide one rather dramatic change in the current year, namely, sharply lower growth in spending on consumer durables. At annual rate, it was down to $23.5 billion in the first seven months of 2004, after $71 billion in 2003 and $58 billion in 2002.

Still, there has been a dramatic change for the worse in the consumer's earning power. Since January 2004, the three-month annualized growth rate for real disposable personal income has literally collapsed: 5.7%, 4.6%, 4.5%, 3.7%, 2.5% and 0.8% for July. Over the seven months to July 2004, real disposable income was up a mere $77.4 billion, or $132.7 billion at annual rate. It grew by $174.3 billion in 2003 and by $226.2 billion in 2002.

Disposable personal income in nominal terms increased by $226.9 billion during the first seven months of 2004. Consumer spending, however, rose by $273.7 billion. Consumer borrowing has been at its highest ever in the first half of 2004, running at an annual rate of around $1,000 billion, compared with $856 billion in 2003. As a result, the consumers' savings rate plummeted to new lows.

Presenting these numbers, we have to mention that they have been jolted by tremendous revisions. Earlier data showed a pronounced rise in personal saving. Now there is a steep plunge. The crucial fact to see is that the consumer stepped up his borrowing to compensate for slowing income growth. The rise since 2000 is 74%. Yet the net effect has been gradual retrenchment in spending.

UNITED STATES: GROWTH OF VARIOUS ECONOMIC COMPONENTS

	2000	2001	2002	2003	2004**
REAL GDP, %	3.7	0.8	1.9	3.0	3.6
REAL DISPOSABLE INCOME*	2.7	139.3	226.2	174.2	132.7
REAL DISPOSABLE INCOME, %	4.8	1.9	3.1	2.3	1.7
REAL CONSUMPTION EXPENDITURES*	300.8	171.0	213.0	232.2	209.5
REAL CONSUMPTION EXPENDITURES, %	4.7	2.5	3.1	3.3	2.8
DURABLE GOODS*	58.7	37.4	58.0	71.0	23.5
DURABLE GOODS, %	7.3	4.3	6.5	7.4	2.2
NONRESIDENTIAL INVESTMENT, %	8.7	-4.2	-8.9	3.3	7.8
RESIDENTIAL INVESTMENT, %	0.8	0.4	4.8	8.8	9.5
NET IMPORTS*	379.5	399.1	472.1	518.5	588.7
PERSONAL SAVINGS RATIO, %	2.4	1.8	2.0	1.4	0.9
INCREASES IN CONSUMER DEBT*	561.0	628.0	731.5	856.6	975.2

* Billions of chained dollars ** At annual rate in current dollars

On closer look, the plunge in the growth of real disposable income during 2004 had two main reasons. One, early in the year there was a sharp rise in the inflation rate, and the other was the end of tax cuts. During the two years 2002–03, personal taxes fell by $234 billion, from $1,235.7 billion to $1,001.7 billion. Important also, the downshift has accelerated. During the three months May–July, real disposable income growth was down to 0.2%, or 0.8% at annual rate.

“SOME TRACTION”

The success or failure of the massive monetary and fiscal stimuli over the past few years is one of the most controversial questions about the U.S. economy. Using the much slower economic growth in the Eurozone as a yardstick, as is the general American practice, U.S. policies look most successful. But using the previous six postwar U.S. business cycles as a measure of success, the U.S. economy's performance during the last two to three years has

been by far the poorest ever, despite the unprecedented amount of fiscal and monetary stimuli.

Annualized growth of real GDP has averaged 3.4% over the first 10 quarters of this upturn, far below the 5.4% norm of the recoveries in the previous business cycles. Real wage and salary disbursements — the grist of healthy, sustainable economic growth — over the same period have recorded a cumulative increase of just 2.2%. This compares with an average cumulative increase of 10.6% over the same period in past postwar business cycles.

Even more important is the further question of whether or not the economy has gained the "traction" it needs for the recovery to become self-sustaining and self-reinforcing without further artificial monetary and fiscal stimuli. It would have to show particularly in much faster employment and income growth than it has so far.

In his congressional testimony, Mr. Greenspan stated, *"The expansion has regained some traction"* after having gone through an oil price-induced *"soft patch"* last spring. In general, this has been interpreted as an upbeat statement. To us, the word *"some"* is strictly diminutive, implying less than full traction, which is realized when an economic recovery has gained self-sustaining, if not self-reinforcing, dynamism.

As a matter of fact, there was a very different reading about consumer spending in the Fed's Sept. 8 Beige Book: *"Household spending was reported to have softened in many parts of the nation, reflecting lackluster retail sales and some cooling in new and existing home sales."* They certainly knew what happened in August.

In past cycles, the usual vigorous traction used to come mainly from pent-up demand that, due to prior monetary tightness, had accumulated during the recession mainly in residential building, consumer durables and business investment in equipment. Key to the present subpar recovery has been the exact opposite — heavy consumer borrowing from the future.

During the three years 2000–03, disposable incomes of private households grew, in current dollars, a cumulative $965.9 billion. They increased their spending by $1,023.7 billion and their debts by a stunning $2,726.9 billion. In this regard, the monetary and fiscal stimuli appear to have worked so far. But the problem is that a growing part of domestic spending exits to foreign producers, fueling the U.S. trade deficit, instead of U.S. domestic production.

THE GREAT INCOME AND PROFIT KILLER — THE TRADE GAP

With great amazement, we have been noting for years that the exploding trade gap plays virtually no role in the discussion of the U.S. economy's growth, although it implies an exactly equivalent subtraction from domestic demand growth. In the second quarter of 2004, the increase in the trade gap subtracted 1.37 percentage points from GDP as determined by domestic demand growth. In total, it amounted to $664 billion at annual rate.

In the 1980s, policymakers and economists greatly worried about the harm that a much smaller trade deficit was doing to U.S. manufacturing. In September 1985, orchestrated by James Baker, America's Treasury secretary, the finance ministers of the G-5 agreed to drive the dollar sharply down in concerted action.

It seems that by the mid-1990s U.S. policymakers came to the conclusion that the developing U.S. trade deficits were in important ways beneficial for the U.S. economy and its financial markets. Cheap imports were playing an important role in preventing wage-push inflation that would have forced the Federal Reserve to raise interest rates to keep inflation in check. The ensuing higher interest rates would have slowed the economy much earlier. Instead, the associated capital inflows certainly helped to keep capital costs low.

This kind of development with monetary tightening was, indeed, the typical postwar business cycle pattern in America as in the rest of the world. For the first time ever, the United States was enjoying a prolonged period of strong economic growth with low inflation and low interest rates.

For us, frankly speaking, all this thinking and arguing is macroeconomics of utter absurdity. Let us start our further comments with a quote about the benefits of capital inflows that hits the nail on the head. It is from Joan Robinson, a close associate of J.M. Keynes:

"The deficit country is absorbing more, taking consumption and investment together, than its own production; in this sense, it is drawing upon savings made abroad. Whether this is a good bargain or not depends on the nature

of the use to which the funds are put. If they merely permit an excess of consumption over production, the economy is on the road to ruin. If they permit an excess of investment over home savings, the result depends on the nature of the investment."

The fact is that U.S. net business investment (that is, after allowance for depreciation) is at an all-time postwar low of less than 2% of GDP, while the net financial inflows are approaching 6% of GDP. In other words, the counterpart to the capital inflows in the U.S. economy has been higher private and public consumption, and so lower saving and investment.

Official and consensus opinions in America say that the huge U.S. trade gap is mainly the fault of foreigners for two reasons. One is the extraordinary eagerness of foreign investors to acquire U.S. assets offering them higher returns than in the rest of the world; the other reason is supposed to be weaker economic growth in the rest of the world. In this view, the trade gap directly results from the capital inflows because it provides the dollars that the foreign investors need.

The first elementary thing to see about a deficit in foreign trade is that, by definition, it reflects an excess of domestic spending over domestic output. But such spending excess is essentially conditioned by domestic credit excess. Capital inflows, driving up the exchange rate, would have the exact opposite effect of contracting domestic demand.

Just as shaky is the second argument, ascribing the trade gap to higher U.S. economic growth. The fact is that the countries of emerging Asia, in particular China, have much higher rates of economic growth than the United States. Yet they all run a chronic trade surplus, which for knowledgeable economists has its obvious reason in their high rates of saving. This, in fact, is the crucial variable concerning the issue of trade surplus or trade deficit.

Now from the causes of the U.S. trade deficit to its implications. The crucial macroeconomic point to see about the trade gap is that the implicit diversion of U.S. domestic spending to foreign producers imparts an exactly equivalent loss of revenue for businesses and consumers in the United States, presently exceeding $500 billion per year. In short, this is America's permanent great income and profit killer.

Basically, this ferocious drag of the big and growing trade gap on U.S. domestic incomes and profits would have bred sharply slower economic growth, if not recession, long ago. But this outcome has so far been prevented by the Fed's extreme monetary looseness, generating alternative domestic demand growth through rampant credit expansion. Implicitly, the rapid rise of the trade gap requires rapidly growing credit and debt creation.

The need for ever-greater credit and debt creation just to offset the income losses on account of the trade gap is the one big problem. The other one concerns the associated further structural distortions. Manifestly, there has been no break with the economy's dismal consumption-savings-investment pattern of the boom years.

The exact opposite is true. Personal consumption in the last few years of subpar growth drastically increased its share of GDP at the expense of saving, while business investment has rebounded sluggishly. During the three years 2000–2003, consumer spending accounted for 109.2% of real GDP growth. Government spending contributed another 33.1%.

Observing this ill-structured pattern of economic growth, it has always been a foregone conclusion for us that it can only end in deadlock. Normally, tight money forces consumers and businesses to unwind their boom excesses during recessions. This time, the Fed's extremely loose monetary stance has induced them to *step up* their boom excesses.

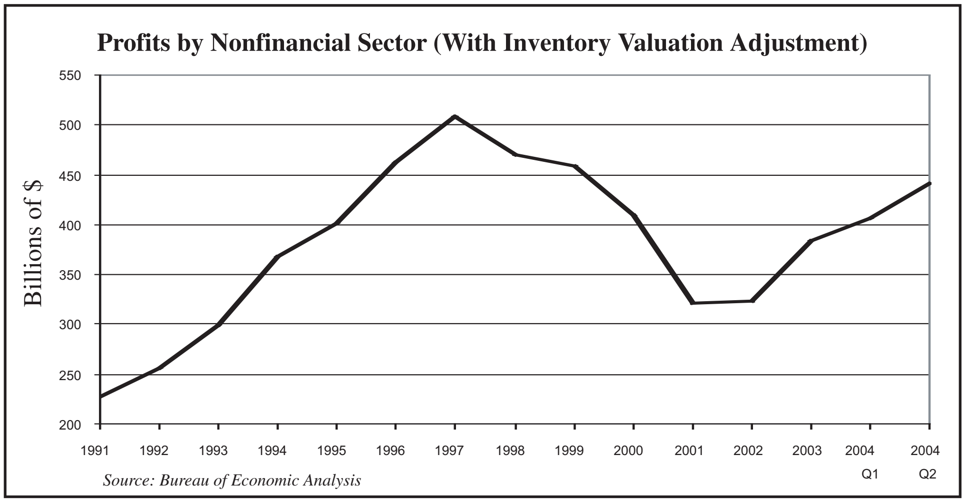
Measured by its persistent runaway money and credit growth, the United States has had the worst inflation in history for many years. Contrary to the regular experience of the past, however, it went overwhelmingly into asset prices — housing, stocks and carry trade — and into a soaring import surplus.

The trouble is that American policymakers and most economists fail or refuse to see the causal connection between rampant monetary excess and the soaring trade gap on the one hand and asset price inflation on the other. The trade gap is hailed as an emblem of superior economic growth, while the hyperinflation in stock and house prices is hailed as wealth creation.

PROFIT MISERY — MACRO BEATS MICRO

Pondering the causes and implications of the economic development in the United States, the year 1997 stands out as the point of inflection from healthy and profitable investment-led economic growth to sickly consumption-driven growth with gross structural distortions, driven by unprecedented credit excess.

Between 1991–97, consumer spending accounted for 67% and nonresidential investment for 23% of real GDP growth. Profits in the nonfinancial sector more than doubled, from $227.3 billion in 1991 to $508.4 billion in 1997. And where are these profits now, after another six years? In 2003, they were at $383.6 billion, and in the second quarter of 2004, at $440.7 billion annualized. So much for the trumpeted recent profit performance.



The best time for business profits is always when the economy recovers from recession, because capital stock that has been idle or underutilized is brought back on line or utilized more intensively. Therefore, normally, profits promptly surge well above their level before the recession.

Not so this time. In fact, they had a sharp recovery from their recession low; however, they are barely level with profits in 2000. Manufacturing profits of $81.5 billion at annual rate in the first quarter of 2004 were far below their level ($144.3 billion) in 2000 and less than half their 1997 level ($209 billion).

During the New Paradigm years of the late 1990s, there was euphoric talk of a profit miracle. The fact is that this miracle only happened in the profit reports of the firms. Anybody who cared to check the numbers of the official National Income and Product Account (NIPA) realized very early that the reality behind the trumpeted profit miracle was extraordinary profit misery. In hindsight, we learned that numerous companies were using every trick to pump reported earnings.

Sure, companies have always tried to present themselves in the best possible light. But many of the practices that hyped earnings in the late 1990s were plainly designed to deceive unwary investors about the financial state of companies. Much of it was flat-out accounting fraud. Though Wall Street knew this without question, it readily played along. Reading frequently of EBITA profits, we realize that nothing has changed.

Pondering the development or the prospects of an economy as a whole, the focus essentially has to be on profits in the aggregate. That is, the combined profits of all firms. Fortunately, available statistics about flows of funds between the various sectors of the economy — households, government, businesses and foreign — offer exact insights about how decisions to invest, save, spend, tax, import, export and so forth impact profits.

We regard this approach as indispensable because it also reveals what the old economists called the fallacy of composition. It is the inclination to assume that whatever increases the profits of a single firm must essentially do the same for profits of the business sector as a whole.

Cutting wages is the most famous, typical case of this fallacy inherent to the micro perspective. Employee costs are, of course, a major influence on corporate profits. For many American managers, cutting payroll expenses is the surest and quickest way to improve their firms' profits. Accordingly, it is commonly assumed that the same must apply to aggregate profits when firms throughout the economy cut their wage expenses.

That is the great micro error. Macro beats micro. For the business sector as a whole, cutting wage expenses reduces aggregate revenues as well. Generally lower wage income means generally lesser purchasing power for

spending on the goods and services produced and sold by the business sector. Corporate America's single-minded pursuit of boosting profits by reducing wages is one of several cardinal micro fallacies of the new corporate governance culture. In a healthy economy, wage costs are lowered by investment.

In reality, there are always many forces on the macro level at work affecting aggregate business profits, and they are the ones that determine economic activity on the whole. Such macro influences are changes in personal saving, in the budget deficit, in business capital investment and in the trade balance.

TRADE DEFICIT — THE UNKNOWN PROFIT KILLER

Complete disregard of macroeconomic implications is also behind the general total indifference to the huge and growing trade deficit. There seems to be a casual perception that outflows and inflows of dollars offset each other.

They do so in the total balance of payments, but not in the economy. The payments for imports exit the domestic income circulation through the current account in the balance of payments. Coming back through the capital account, these dollars flow into the U.S. financial markets outside both GDP and income circulation. In the first case, the economy loses spending and income creation; the return flows, on the other hand, increase the demand for assets in the United States. That is why Wall Street loves this imbalance.

Earlier we pointed out that for U.S. producers the trade deficit implies an equivalent loss of revenue. Unlike wages paid to domestic workers, which return to their employers as revenues through purchases of goods and services, payments to foreign producers are definitely lost for the U.S. economy. What is more, a large part of the money spent on foreign goods derives from the wage payments of U.S. producers, implying a double whammy on profits.

Considering the enormous size of the U.S. import surplus, there can be no question that it has played a major and rapidly rising role in inhibiting a stronger and sustained economic recovery. In actual fact, it is the main channel through which Corporate America outsources jobs, profits and incomes.

MACRO PROFIT SOURCES

As pointed out, the general attempt of American businesses to improve their profits through cutting wages is self-defeating. We call it the deflationary micro fallacy, because it essentially reduces the overall level of spending in the economy. The wages and salaries that businesses pay are the incomes of their workers, who recycle them back to their employers by purchasing the goods and services the businesses produce. In this way, lower wages implicitly translate into lower business revenues.

If households spend every dollar earned, business revenues from this source are exactly equal to wage expenses, whatever the level of wages. There is neither loss nor profit.

This simple equation highlights an insight. Spending from earned wages is not likely to generate profits. The obvious reason is that these business revenues have their counterpart in business expenses. For a business to make profits, they need additional revenues from expenditures involving lesser, or no, expenses.

This brings us back to the earlier remark about potential macroeconomic flows impacting business profits *in the aggregate*. We noted changes (1) in personal saving and consumer borrowing, (2) in the budget deficit, (3) in business net investment and (4) in the trade balance.

Of these four major profit sources on the macro level, in the past few years two have been highly positive for U.S. business profits and two were highly negative. The positive ones were the continuous collapse of personal saving and the soaring budget deficit; the highly negative ones were the soaring trade deficit and a virtual collapse of business net investment.

How do changes in personal saving affect profits? Savings is the part of current income that is not spent, but diverted into the financial system. To this extent, saving reduces the flow of revenue to businesses. With business expenses unchanged, businesses suffer a corresponding loss of revenue, at the expense of their profits.

Logically, the opposite occurs when households slash their savings. In this case, business revenues increase

faster than their expenses — to the benefit of business profits. A literal collapse of personal saving over many years, particularly since 1997, has been a main source of profits for U.S. businesses. American businesses, cutting wage expenses, were lucky in that their workers and employees replaced the missing income from wages and salaries with credit-financed spending.

Yet the single biggest source of profits since 2000 has been the federal budget deficit. With tax cuts and higher spending, the government provides the private sector, both consumers and businesses, with an equal amount of additional income. Consider: In 2003, the U.S. federal government ran a deficit of $396 billion, against a surplus of $295.9 billion in 2000. The two add up to an overall financial swing in the budget of almost $700 billion, or $233 billion per year.

While the budget deficit keeps posting new records, it has drastically lost its impact on income creation. What matters in this respect is the deficit's current growth, not its level. The sharply slower increase of the federal deficit essentially implies sharply slower government-induced income creation in the private sector.

Summarizing from the macro perspective, the U.S. economy during the past three years of subpar growth has received major positive profit impulses from consumer and government borrowing or dissaving. On the other hand, the big and soaring trade deficit acted as a simultaneous very big killer of business profits.

This brings us to the second profit killer of major proportions since 2000: collapsing business net investment.

THE OTHER BIG PROFIT KILLER — COLLAPSING NET INVESTMENT

We realize that this influence, too, is generally completely ignored. Though we have repeatedly explained in past letters how this profit source works, its great importance justifies repetition.

In actual fact, business net fixed investment is typically the largest and most important profit source of businesses because — in the aggregate — it generates immediate business revenue without generating immediate business expenses. There was a popular saying among Keynesians in the 1920s that workers spend what they earn, but capitalists earn what they spend.

How does this work? For the explanation, we would like to quote Keynes himself:

First, "entrepreneurs pay out in salaries, wages, rents and interest certain sums to the factors of production which I shall call their 'costs of production.'"

Second, "the costs of production of the entrepreneurs are equal to the incomes of the public."

Third, "the incomes of the public are equal to the sum of what the public spends on current consumption and what it puts as saving into the financial machine."

Fourth,"the receipts of the entrepreneurs are equal to what the public spends plus the sums that the entrepreneurs spend on capital investment."

The last sentence is really the one of decisive importance: There are in reality two different major streams of spending flowing to the entrepreneurs, namely, what the public spends on consumption and what businesses spend on capital investment. These two amounts added together make up the proceeds of the entrepreneurs.

Keynes says, *"It follows, if you have been able to catch what I am saying, that when the value of current investment is greater than the savings of the public, the receipts of the entrepreneurs are greater than their costs, so that they make a profit."*

Keynes omitted to mention explicitly that this profit effect applies only to net business investment, not to gross investment, including a large component of depreciations, which incur further expenses.

Net investment means that investment spending exceeds depreciations. In 2000, the U.S. economy had net business fixed investment of $404.8 billion, up from $110.4 billion in 1991. But in 2003, it was down to $154.5 billion. This steep decline had its cause in the fact that the increase in gross investment since 2000 has fallen heavily

short of rising depreciations on past investments. In other words, investment expenses rose faster than business revenues from investment spending. (High-tech investments, by the way, are a particular problem in this respect, because high-tech's very short life spans imply rapid depreciations.)

This positive macro effect of business net investment on aggregate profits — emphasis again on "aggregate" — accrues, in actual fact, because investment spending always involves two different groups of firms: those that do the capital investment and those that produce the necessary capital goods.

The crux is that the investing firms do not have an immediate expense, because they capitalize them in their balance sheets. In contrast, the firms producing and selling the capital goods book these payments as immediate revenue. As a result, business revenues and profits in the aggregate are correspondingly boosted. Consider that net investments in 2000 amounted to $404.8 billion. In the case of the investing firms, no expense is incurred until the first depreciation charge is recorded.

It may seem outlandish to go into these details. But knowledge of them is crucial for an understanding of the U.S. economy's poor profit performance. The consensus in the United States regards "pricing power" — in other words, sufficient inflation in producer prices — as the business sector's predominant profit source. It is another great fallacy in economic thinking. Gross lack of business revenue from net investment spending in the U.S. economy is one main deficiency behind the poor profit performance, and the monstrous trade deficit is the other.

POOR PROFIT PROSPECT

We identified four major macroeconomic profit sources: changes in household saving, changes in budget deficits, changes in the foreign trade balance and changes in net business investment. As pointed out earlier, the first two were the U.S. economy's positive profit sources since 2000, while the second two have been heavily negative. The vexing question now is their further development.

The obvious biggest negative for current and future business profits in the United States now is fiscal policy. As fiscal profligacy has been spent, the current growth of the federal deficit has drastically subsided to around $50 billion per year, as against more than $200 billion per year in the recent past. Essentially, this means an equally drastic cut in the government's current income and profit creation.

As to personal saving, we assume a gradual, though accelerating, increase. As the phony "wealth creation" through rising stock and housing prices belongs definitely to the past, people will rediscover saving from current income. Stock and housing values can only decline.

As to the trade deficit, it had been our assumption that slowing U.S. demand growth will contain it. The recent horrible trade figures have shaken this assumption.

That leaves us with one single potential profit source: net business fixed investment. It is really the capitalist economy's strategic key variable. It is the one and only demand component that powers the economy in a sustainable way. Its first effect, the demand effect, is employment and income creation through the production of capital goods. Its second effect, the supply effect, starts with the installation of these capital goods. New factories and new equipment increase employment and incomes through increased production. Another most important aspect is that all this is self-financing in the long run through depreciations and reinvestment, meaning employment growth without debt growth.

For the old economists, it was fundamental that a high level of capital spending, implying the production of capital goods, represented an indispensable condition for sustained growth of profits, employment and incomes. The U.S. economy is grossly short of this condition, and we do not see a change for the better.

Business capital spending has been the great laggard in the current U.S. recovery. It has rallied in 2004, but its growth badly lags the typical investment recovery of the past. It has barely reached its 2000 level. What is more, it has probably already peaked. The accelerated depreciation allowances that were part of the last tax cut package will expire at the end of this year.

Most revealing about business attitudes and policies is probably the news about surging corporate stock buybacks. In July alone, buyback announcements amounted to $38.7 billion — the strongest such surge in 20 years. As the tax rate on dividends has been brought in line with that on stock buybacks, some analysts wonder about the reason for this boom in stock buybacks. To us, the reason is obvious: In America's business culture, boosting share prices has priority over organic growth through new investment.

IT IS MORE CRITICAL THAN IN 2000

So much for the recent past and the present. The critical question now is what is going to happen in the foreseeable future. It is definitely the most critical juncture for the U.S. economy and the world economy, far more critical than in 2000–01.

At the time, both the Federal Reserve and the government had a large armory of stimulatory measures at their disposal to fight the economic downturn. Both monetary and fiscal stimuli were applied with unprecedented aggressiveness. Measured by real GDP growth, the economic downturn has been mild when compared to previous postwar recessions. But the prodigious stimuli have totally failed to spark the normal self-sustaining and self-reinforcing expansion. Measured by the extremely poor employment, America is facing a policy disaster.

Why?

In the spring of 2002, Mr. Greenspan opined that *"imbalances that triggered the downturn and that could have prolonged the difficult period did not fester."* In his view, information technology, together with financial innovation and deregulation made it possible to address and resolve imbalances far more rapidly than in the past and thereby reduce the cyclical swings in economic activity.

The trouble with this glorification of events is that the existing structural imbalances in the economy — primarily far too much consumption and far too little capital investment — have actually worsened dramatically during the past few years of reflation.

Plainly, the monetary and fiscal measures applied gave the economy a brief boost, but they completely failed to restore a pattern of potential, sustainable economic growth. Actually, just the reverse happened: Bubble-driven consumer spending increased its disproportionate share in driving the economy.

The key conditions for a self-sustaining recovery are sharply higher employment and income creation. The recovery of the past few years accrued mainly from income creation through the soaring budget deficit and bubble-driven, runaway growth of consumer spending. But while government and consumer debt exploded, the employment and income effects have been grossly insufficient.

It has been our contention that after the income tax cuts have been spent, the growth of disposable income of private households would sharply subside in 2004. To our great surprise, it held up in the first half, with $330 billion at annual rate on the high side. The puzzle has been solved. There were no tax cuts, but huge individual tax refunds, amounting until May to $200 billion (not annualized). June and July were the first two months without major tax refunds — with growth of disposable income at an annual rate of around $120 billion.

In the absence of tax cuts and tax refunds, the growth of personal disposable income has collapsed. One obvious major cause, though certainly not the full explanation for this deficiency, is the huge and soaring U.S. trade deficit fueling employment and income growth abroad. Pondering the U.S. economy's further prospects, the important thing to see is that this leaves but two possible alternatives for stronger employment and income growth. One is a sharp acceleration in business capital spending, and the other is a drastic improvement in the U.S. trade deficit. Neither, however, is in the cards.

Comparing the present economic situation with that in 2000, we see two crucial differences: *First*, there are very few ways left for the government and the Federal Reserve to fight the economy's new downturn; and *Second*, the economy and its financial system are far more vulnerable.

THE WORLD'S OTHER ENGINE OF GROWTH — CHINA

In assessing the world economy's prospects, it is necessary to pay increasing attention to the development in China. Together with the United States, it has become the locomotive of the world economy. But that is only true for the Asian economies, including Japan. During 2003, no less than 58% of China's imports of goods and services came from Asia, as against 8% from the United States and 13% from the European Union. In short, China is running a big trade deficit within the region.

In the case of Japan, exports to China accounted for 32% of total export growth in the course of last year. In the case of Korea, the share was 36%, and in the case of Taiwan, it was even 68%. The booming trade surplus with China was the spark that powered Asia's nascent cyclical recovery last year

But this trade deficit with the Asian countries has been more than matched by trade surpluses earned with the United States ($88 billion in 2003) and with the European Union ($29 billion).

During the first half of 2004, China's U.S. surplus was up to $137 billion at annual rate. Overall, China had a trade surplus of about $29.6 billion in 2003.

While the overall trade balance did not change significantly during 2001–03, there have been significant shifts in regional trade balances. China's trade balance with the United States and the European Union is rapidly rising, but are being more than offset by rising deficits in Asia.

We wonder, however, how much of the export to China from America, Europe and Japan in reality reflects direct investments of firms of these countries expanding their operations to China in order to take advantage of rock-bottom labor costs and strong future demand growth.

Now comes an interesting point. Given capital controls and a modest overall trade surplus, one would think that large inflows of foreign exchange are possible. But the point is that the large direct investments from the industrial countries grossly distort the trade picture. In China's trade statistics, these foreign direct investments show as imports of goods. But these imports involve no payments on the part of China.

The result is that China, regardless of capital controls, enjoys a huge net inflow of foreign exchange. In 2003, the central bank's foreign exchange reserves increased by $116.8 billion, to $403.2 billion, against a trade surplus of only $29.6 billion. Until April 2004, these reserves had further risen to $449 billion.

For good reasons, China's economic performance is admired around the world. Its real GDP growth has recently been around 9% per year, even after 12% in prior years. More remarkably, no less than 47% of China's GDP has been devoted to capital investment.

An existing chronic trade surplus suggests, on the other hand, that this ferocious investment boom is fully covered by private domestic saving. The government is running a deficit of close to 3% of GDP.

Fearful of overheating inflation rates and structural distortions, the Chinese authorities have taken action to slow economic growth. Whether or not they will succeed in managing a soft landing has become one of the great themes being pondered and discussed around the world.

With exports and imports both soaring at annual rates of around 40%, the Chinese economy has suddenly gained outstanding importance in the global economy. Clearly, it has become the locomotive for all of East Asia, running substantial trade deficits with them. These have their main counterpart in the large trade surplus with the United States.

But China's locomotive, in turn, is the U.S. economy. The pull is taking place through two channels: trade and soaring dollar flows to China. During the past two years, U.S. imports from China have sharply accelerated, rising at an annual rate of 18%, in nominal terms. The "real" increase is undoubtedly much greater, since the average price of imports from China has been falling. Over the same period, imports from other countries have increased at a much slower rate of 3.5% — a rate that is broadly in line with recent U.S. GDP growth.

Our particular focus, though, is on the escalating monetary linkage between China and the United States. That

is the linkage where, as a rule, the problems loom. Here, too, the year 2000 marks a drastic rupture. Up to then, the dollar reserves of the Bank of China had been increasing modestly, from $105 billion in 1996 to $165.6 billion in 2000. But during the following 3 1/2 years until April 2004, they soared to $449 billion. Particularly in 2003, China's central bank became a big dollar buyer at a fixed exchange rate.

This had sweeping monetary consequences. Domestic bank credit surged by 83%, compared with an increase by 49% in the prior three years.

Yet more recently, there has been a pronounced slowdown, apparently implemented by more drastic administrative measures.

For us, today's China is the parallel to Japan in the late 1980s. The runaway bubble in building and business fixed investment threatens to leave behind collapsing property prices, vast amounts of excessive industrial capacity and lots of bad debt. Yet there are some important differences: *First*, the investment excesses vastly exceed those in Japan, implying even more extensive malinvestment; *second*, there is a property bubble, but no stock market bubble; and *third*, the government owns all banks.

BOOMING ASIA

Virtually through all of Asia, governments have tied their currency at a fixed or quasi-fixed rate to the dollar. With their foreign trade generally in surplus, the central banks have for years intervened heavily in the exchange markets to prevent or limit the appreciation of their currencies against the dollar.

It strikes us as rather ominous that these dollar purchases by Asian central banks have multiplied since 2000, due to an escalating U.S. current account deficit. During the second quarter of 2004, this U.S. deficit amounted to $664.8 billion at annual rate, after $588.8 billion in the prior quarter and $411.5 billion in 2000. That is an increase by more than 50% in just three to four years. It is ominous in our view because U.S. domestic demand has slowed, while Asia has sharply accelerated growth.

In 2000, the central banks of emerging Asia acquired $52.5 billion. In 2003, it was more than five times that amount — $263.9 billion. As already mentioned, the dollar reserves of China's central bank soared between 2000 and April 2004 from $165.5 billion to $449 billion; that is, by $283.5 billion. This compares with an increase during the prior three years by $25.6 billion, to $165.5 billion.

The decisive difference between the two areas, obviously, is that the Asian economies get their growth dynamic from saving and investment, while the U.S. economy gets it from consumption and "wealth creation" through asset price inflation. Importantly, both sides appear manifestly satisfied with the net economic result on their part. We think both sides neglect the horrendous longer-term costs of their policies.

It is often argued that the Asian central banks will bring on huge losses when the dollar finally falls. For sure, the banks know that. But they do not care about these future currency losses. In their view, they are grossly outweighed by the inherent current gains through higher economic growth. That is, of course, precisely what Japan's policymakers thought when they obliged their central bank to prevent an undesired yen appreciation with massive interventions.

Really, the key problem with the large-scale dollar purchases by central banks is that they pay for them by creating liabilities to the commercial banks in the form of deposits, generally referred to as bank reserves or high-powered money. Availability of bank reserves tends to set the limit on overall lending by the banking system.

Bearing no interest, the banks want to get rid of reserves in excess of requirements by increasing lending. In this way, rising bank reserves generally spark off a general process of accelerating credit and money growth. Typically, banks in many Asian countries have embarked on rampant credit inflation with two macro characteristics: an investment boom accompanied by asset price inflation.

HIGH-CONSUMPTION AMERICA VS. HIGH-INVESTMENT ASIA

Basic to all Asian countries is one macro problem — too much personal saving and too little private

consumption. It is, by the way, also the key problem of the Eurozone, though on a more moderate scale. Although continental Europe is investing a considerably higher share of GDP than the United States, it falls short of the high rates of personal saving. The French and Germans save on average around 11% of their disposable income.

In the United States, this rate lately is close to zero. As a matter of fact, it is also substantially negative in Australia and New Zealand and very low in England. As a rule, strong economic growth arises when investments exceed savings, while weak growth arises when savings exceed investments. Paradoxically, the United States has solved the growth problem by equilibrating record-low investment with record-low national saving.

One could say that this "division of labor" between overconsuming and overproducing countries solves the problem on the international level. But it is all about sustainability.

The bullish consensus in America assumes that central banks in general, and the Greenspan Fed in particular, joined by highly flexible and efficient markets, are sure to cope with all problems. For sure, the experience of the past two to three years encourages their belief.

This view overlooks two things of crucial importance: *first*, that the policy excesses in America — and some other countries — during the past few years have resulted in a grossly distorted, artificial and fragile recovery; and *second*, that under persistent excessive monetary looseness, growth-impairing imbalances in the U.S. economy have tremendously festered. Think of near-zero personal savings and record-high debts, the ballooning twin deficits and poor profit performance.

Of course, the U.S. economy has been the locomotive for the rest of the world for years, but what this actually has reflected is definitely not economic strength, but unprecedented American credit and debt excess, accommodated by buoyant foreign purchases of U.S. assets. Internal American indebtedness since 2000 has surged by $8,211.3 billion, or 31%. External net indebtedness almost doubled to around $3,000 billion.

CONCLUSIONS

Among the industrial countries, the economic news is generally disappointing prior high expectations. The U.S. economy in particular shows a more pronounced slowdown. Recognizing the main causes in developing poor profits and personal income growth, we regard this slowdown as definite and prone to worsen.

Both the resurgent U.S. bond market and the sputtering stock market apparently do not concur with Mr. Greenspan's "soft patch" appraisal that the U.S. economy's ills are transitory.

It was in particular the surge in the employment numbers through the phony "net birth/death" computer model, accounting for two-thirds of the reported increase, which has created false optimism about the U.S. economy.

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